SUPREME COURT, U. S.

Supreme Court, U.S.
FILED
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E. ROBERT SEAVER, CLERK

IN THE

Supreme Court of the United States

October Term, 1970

No. ~~1159~~ 70-60

SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK, as Liquidator of MANHATTAN CASUALTY COMPANY,

Petitioner,

against

BANKERS LIFE AND CASUALTY COMPANY, IRVING TRUST COMPANY, BELGIAN AMERICAN BANKING CORPORATION, BELGIAN AMERICAN BANK & TRUST COMPANY, GARVIN, BANTEL & COMPANY, GEORGE K. GARVIN,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

RESPONDENTS' BRIEF IN OPPOSITION

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RESPONDENTS' BRIEF IN OPPOSITION

Preliminary Statement

This brief is submitted in opposition to the petition for a writ of certiorari to the United States Court of Appeals for the Second Circuit seeking review of the judgment of that Court which affirmed judgments of the United States District Court for the Southern District of New York dismissing the complaint for lack of subject matter jurisdiction.

Questions Presented

None of the five numbered questions set forth in the Petition justifies review by this Court of the decision below. Questions "1," "2" and "5" concern no more than peti-

tioner's mistaken contention that conduct allegedly constituting corporate waste and mismanagement is a violation of the federal securities acts merely because certain securities transactions occurred incidental thereto. Question "4" seeks abolition of the purchaser-seller requirement first enunciated in *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied,* 343 U.S. 956 (1952), though its abolition would not affect the result reached by the court below. Question "3" asserts a conflict between two Circuits which does not exist.

Statement of the Case

Petitioner initiated this action in August 1963 and alleged in his complaint, as the sole jurisdictional basis for the action, "violations of Section 17A of the Securities Act of 1933 (15 U.S.C.A. §77q(a))." Commencing with the respondents' answers to the complaint, and from time to time thereafter, petitioner was put on notice of the lack of federal jurisdiction. In August 1967 petitioner represented that he had completed all of his pretrial discovery by filing the required Note of Issue in which he again stated that "a violation of Section 17(a) of the Securities Act of 1933" was the jurisdictional basis for the action.

The essence of the complaint is that the late James F. Begole, a defendant who was the sole purchaser of all of the outstanding capital stock of Manhattan Casualty Company ("Manhattan"), engaged in a scheme, with others, to deplete and misappropriate assets of Manhattan and to conceal that misappropriation from the Superintendent of Insurance of New York. In 1965, in the midst of pretrial discovery and in apparent recognition of the absence of federal jurisdiction, petitioner commenced an action—still pending—in the Supreme Court of the State of New York against the same defendants, alleging virtually the same facts, and seeking relief under state law identical to the relief sought in this action.

In an order dated June 19, 1968, the District Court (Hon. Sylvester J. Ryan) questioned its jurisdiction over the subject matter of the action and indicated the need for resolution of that issue.* Respondents thereupon moved to dismiss the complaint under Rules 12(c) and 12(h) of the Federal Rules of Civil Procedure on the grounds that the District Court lacked subject matter jurisdiction and that the complaint failed to state a claim under federal law.

On June 3, 1969, the District Court (Hon. William B. Herlands) filed its opinion granting the motions of respondents Bankers Life and Casualty Company, Belgian-American Banking Corporation and Belgian-American Bank & Trust Company. (App. D).** On June 9, 1969, that court (Ryan, J.) filed a second opinion granting similar motions of respondents Irving Trust Company, Garvin, Bantel & Company and George K. Garvin. (App. E). On July 22, 1970, the Court of Appeals for the Second Circuit affirmed the judgments dismissing the complaint. (App. A). Petitioner's motions for rehearing and rehearing *en banc* were denied on September 30, 1970. (App. B and C).

In opposing respondents' jurisdictional motions and in connection with his application for leave to amend the complaint, petitioner resorted to use of the entire record accumulated during the four years of pretrial discovery. For the first time he asserted that federal jurisdiction was based upon Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78j(b)) and Rule 10b-5 promulgated thereunder. Judge Herlands considered the motions to dismiss on the basis of the allegations of the complaint, the additional facts presented in petitioner's brief and petitioner's "amendatory allegations presented in open court."

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* Thereafter, petitioner served a "Preliminary Pre-trial Memorandum" in which he again claimed as the sole basis for federal jurisdiction that "This action is based on Section 17A of the Securities Act of 1933 (15 U.S.C.A. 77q(a))."

** Appendix references are to the appendices to the Petition.

(App. D, p. 44a). After a comprehensive analysis of all of the facts presented by petitioner, Judge Herlands concluded that the "complaint in this case presents no more than a complicated scheme of common law fraud" and held that there was no federal jurisdiction under either the 1933 or 1934 Acts. (See App. D, p. 56a).

Judge Ryan, in granting the motions before him, expressed full agreement with the opinion of Judge Herlands and also found that the "fraud alleged was not in the purchase or sale of securities, but was waste of Manhattan's assets by diversion and misappropriation of its securities." He further agreed "with Judge Herlands that 'the complaint in this case presents no more than a complicated scheme of common law fraud' over which there is no independent federal jurisdiction." (App. E, p. 58a). Judge Ryan expressly stated that the dismissal of the complaint was without prejudice to the prosecution by petitioner of his pending New York Supreme Court action. (App. E, p. 58a).*

Similarly, the Court of Appeals in affirming the judgments of the District Court stated that it did "not decide that the creditors of Manhattan do not have any remedy under general state tort law for the fraud practiced on their debtor, but only that the federal Securities Acts have not provided a federal forum for its enforcement." (App. A, p. 12a).

As the opinions of the courts below and the Petition itself plainly evidence, the facts presented by this case are "highly individualized". (App. D, p. 51a, n.16). For this reason and because, as will hereinafter appear, the grounds upon which the Petition is based do not present any "spe-

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* New York Civil Practice Law and Rules, Rule 3117(c), provides in part: "When an action has been brought in any court of any state or of the United States and another action involving the same subject matter is afterward brought between the same parties or their representatives or successors in interest all depositions taken in the former action may be used in the latter as if taken therein."

cial and important reasons" justifying further review of the questions decided below, it is respectfully submitted that the Petition should be denied.

Reasons For Denying the Petition

I.

Petitioner has failed to state any claim under the Federal Securities Acts.

Petitioner asserts that during the course of certain transactions, which occurred between January 1962 and April 1963, Manhattan was defrauded of certain assets by defendant Begole and others, that those assets were used to finance Begole's acquisition of the outstanding capital stock of Manhattan, and that the misappropriation of Manhattan's assets was concealed in a complex series of transactions. Petitioner contends, in effect, that Begole's self-inflicted fraud as the sole stockholder-purchaser of Manhattan is actionable under the federal securities laws merely because securities transactions occurred incidental to it.

While in his complaint petitioner alleged that the 1933 Act was violated by defendant Begole's purchase of the outstanding Manhattan capital stock, in opposing respondents' jurisdictional motions he reformulated his theory and urged that the alleged misappropriation of Manhattan's assets violated the securities laws because Manhattan's government securities were sold and various certificates of deposit were purchased. (App. D, p. 44a).*

* There is no need for respondents to be drawn into any dispute as to those matters which are set forth as purported facts in the Petition's "Statement of the Case" and which bear little resemblance to the allegations of the complaint or the pretrial discovery record. The Court of Appeals, as the Petition acknowledges (p. 13), in affirming the judgments of the District Court, considered petitioner's version of the facts and concluded that a federal claim had not been stated.

Petitioner has never claimed, and after extensive pretrial discovery is unable to claim, either that the alleged misappropriation of Manhattan's assets resulted in any injury to any shareholder or investor or that any market for any security was manipulated or otherwise abused.

Petitioner's disagreement with the decision of the Court of Appeals is primarily based upon what he characterizes as the "terms of the sale test". (See Petition, pp. 14-16, 18, 21). Petitioner mistakenly contends that the Court of Appeals held the federal securities laws inapplicable by looking only to "the terms of the sale" of the various securities involved. The contention is demonstrably incorrect.

The Court of Appeals held, as did the District Court, that a federal claim had not been stated because the misappropriation of Manhattan's assets was not, in the language of the 1934 Act, a fraud "in connection with the purchase or sale of any security." In interpreting those words the courts below did not confine themselves to any "terms of the sale test", but properly inquired into the scope and purpose of the Congressional enactment. (App. A, pp. 11a-12a; App. D, pp. 49a-50a). As was so clearly stated by the Court of Appeals:

> "The fraud alleged in this case in no way affected either the securities markets or the investing public. No stockholders were defrauded, no investor injured. The purity of the security transaction and the purity of the trading process were unsullied. There was no danger that the securities sold would be overvalued on reaching the public markets." (App. A, p. 11a).

The Court of Appeals went on to state that the civil liabilities provisions of the federal securities acts "were 'part of a broad integrated program designed to obtain honest dealings in securities,' *Wilko* v. *Swan,* 127 F.Supp. 55, 58

(S.D.N.Y. 1955), not one to create an unlimited federal right of action for damages for all who have been defrauded in any area of economic activity." (App. A, pp. 11a-12a).

The acts of corporate waste and mismanagement alleged by petitioner do not constitute wrongs which the federal securities laws were intended to remedy. As the Court of Appeals for the Fifth Circuit recently stated in *Herpich* v. *Wallace,* 430 F.2d 792, 809 (1970):

> "If Congress had intended that the federal courts inquire into every decision affecting the management of corporations and then fashion a new federal law superseding state law on the fiduciary responsibility of corporate directors, officers, and controlling persons, presumably so revolutionary a federal intervention into an area traditionally handled by the states would have been clearly expressed."

II.

The decision of the Second Circuit is not in conflict with the decision of the Fifth Circuit in *Hooper* v. *Mountain States Securities Corp.*

Petitioner claims that the decision of the Court of Appeals for the Fifth Circuit in *Hooper* v. *Mountain States Securities Corp.,* 282 F.2d 195 (5th Cir. 1960), *cert. denied,* 365 U.S. 814 (1961), which also decided *Herpich* v. *Wallace, supra,* conflicts with the decision of the Court of Appeals for the Second Circuit in this case. In so arguing, however, petitioner ignores the fact that in *Hooper* the Court of Appeals found the relationship, absent in this case, which must exist between an alleged fraud and a securities transaction for a federal claim to be stated.

In *Hooper,* a trustee in bankruptcy was permitted to maintain an action on behalf of a corporation whose stock had been issued and, without registration, distributed to the public. It was held that the plaintiff sufficiently alleged a violation of federal law because the transfer agent for the corporation was induced, by fraudulent representations of the officers of the corporation, to issue stock of the corporation for inadequate consideration, so that the corporation was found to be a defrauded "seller" of that stock. As Judge Herlands, in examining *Hooper,* stated below:

> "Because the purpose and object of the scheme were to have valuable corporate stock issued . . . in exchange for worthless consideration, and then to distribute the stock publicly, the fraud was definitely 'in connection with' the purchase and sale of securities. The scheme induced an unfair sale of securities and it had as a major purpose the spread of watered stock to many investors." (App. D, p. 55a).

Petitioner has never contended that any comparable wrongdoing occurred in this case. Analyzing petitioner's version of the facts and the relevant statutory provisions, the courts below found that no federal claim could be asserted because, unlike *Hooper,* this case involves no manipulation or other abuse of any securities market or the trading process, no impurity of any security transaction, and no possibility of any injury to shareholders or the investing public.

Accordingly, the decision of the Court of Appeals for the Second Circuit herein is fully consistent, and not in conflict, with the decision of the Court of Appeals for the Fifth Circuit in *Hooper.*

III.

The purchaser-seller requirement of *Birnbaum* v. *Newport Steel Corp.* should not be reviewed on the record in this case.

The courts below held that petitioner, suing on behalf of Manhattan, had no standing to assert any federal claim with respect to the sale of the Manhattan capital stock since Manhattan was neither a purchaser nor a seller of those securities. *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). *Birnbaum* held that only a defrauded purchaser or seller could maintain a private damage action under Section 10(b) of the 1934 Act for alleged fraud "in connection with the purchase or sale of any security." That holding has been uniformly and repeatedly followed by every Circuit considering the issue. See *Greenstein* v. *Paul*, 400 F.2d 580 (2d Cir. 1968); *Herpich* v. *Wallace*, 430 F.2d 792 (5th Cir. 1970); *Mader* v. *Armel*, 402 F.2d 158 (6th Cir. 1968), *cert. denied sub nom. Young* v. *Mader*, 394 U.S. 930 (1969); *Dasho* v. *Susquehanna Corp.*, 380 F.2d 262 (7th Cir.), *cert. denied sub nom. Bard* v. *Dasho*, 389 U.S. 977 (1967); *The Greater Iowa Corp.* v. *McLendon*, 378 F.2d 783 (8th Cir. 1967); and *Erling* v. *Powell*, 429 F.2d 795 (8th Cir. 1970).

Only one year ago, the Court of Appeals for the Second Circuit reaffirmed the purchaser-seller requirement. *Iroquois Industries, Inc.* v. *Syracuse China Corp.*, 417 F.2d 963 (2d Cir. 1969), *cert. denied*, 399 U.S. 909 (1970). The court, in that case, stated:

> "The *Birnbaum* rule recognizes the policy of Congress in enacting Section 10(b) and of the Commission in adopting Rule 10b-5, namely, the protection of defrauded purchasers and sellers. It is not the province of the courts to extend Section 10(b) to apply

to transactions not intended to be covered by Congress. We do well to heed the words of Mr. Justice Black, writing for the Court in a case about another section of the 1934 Act, *Blau* v. *Lehman*, 368 U.S. 403, 413, 82 S. Ct. 451, 457, 7 L. Ed. 2d 403 (1962):

> 'Congress can and might amend [the Act] if the Commission would present to it the policy arguments it has presented to us, but we think that Congress is the proper agency to change an interpretation of the Act unbroken since its passage, if the change is to be made.'" 417 F.2d at 969.

Petitioner nevertheless asserts that the long-standing purchaser-seller requirement should be abolished. He argues that the holding that he has no standing to assert a federal claim with respect to the sale of the Manhattan capital stock presents to this Court the question of whether that requirement should be eliminated. However, review of that requirement by this Court is not merited on the record in this case because the decisions of the courts below would not be changed even if the purchaser-seller requirement were abolished.

The courts below held that petitioner did have standing to assert a federal claim with respect to the sale of Manhattan's Government securities. Nevertheless, the courts concluded that petitioner was unable to plead a federal claim. (App. D, pp. 44a, 47a-48a; see App. A, p. 9a). The reasoning of the courts below (see Point I *supra*) in concluding that petitioner could not plead a federal claim applies not only to the sale of Manhattan's Government securities and the purchase of certificates of deposit but also to the sale of the Manhattan capital stock. In fact the District Court explicitly held that, assuming petitioner's standing to assert a federal claim with respect to the sale of Manhattan's stock, no federal claim could be stated on behalf of Manhattan with respect to the sale of those securities. (App. D, p. 48a) The reasoning of the Court of Appeals compels the same result.

Any standing to sue which might be afforded petitioner by abolition of the *Birnbaum* rule would not cure the jurisdictional deficiency of the complaint, because petitioner would still have nothing more than a claim based upon an alleged misappropriation and waste of corporate assets to which certain securities transactions were incidental. As the District Court observed in *Pettit* v. *American Stock Exchange*, 217 F.Supp 21, 25 (S.D.N.Y. 1963):

> "[C]ourts have been disinclined to allow 'innumerable facets of internal corporate affairs' to be included within federal question jurisdiction on the basis of a purchase or sale of securities that is only incidental to a major mismanagement issue."

Since the outcome of this case cannot be affected by the abolition of the purchaser-seller requirement, it is respectfully submitted that this is not a proper case for its review.

Conclusion

The Petition is devoted in large part to a restatement of the purported facts of this case and to a renewed effort by petitioner to discover a formulation of those facts which may create a suggestion of federal jurisdiction. Notwithstanding the effort made, the Petition describes no more than a claim of misappropriation of corporate assets and corporate waste. Such a claim does not provide a basis for federal relief.

Petitioner's contention that a conflict exists between the decision of the Second Circuit in this case and the decision of the Fifth Circuit in *Hooper* is erroneous. Even a cursory review of *Hooper* indicates that the facts present in that case were a paradigm of the evils which Congress sought to prevent by enacting the federal securities laws. In contrast, as the courts below indicated, the facts alleged here present no more than a common law fraud not cognizable under the federal securities laws.

The argument that the purchaser-seller requirement should be set aside has uniformly been rejected. In any

event, that requirement should not be reviewed in this case, the outcome of which cannot be affected by its abolition.

Finally, the issues presented in this case have been carefully examined and correctly determined by the courts below and do not present a suitable occasion for this Court to exercise its discretion to review them.

The Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit should be denied.

Respectfully submitted,

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February 19, 1971

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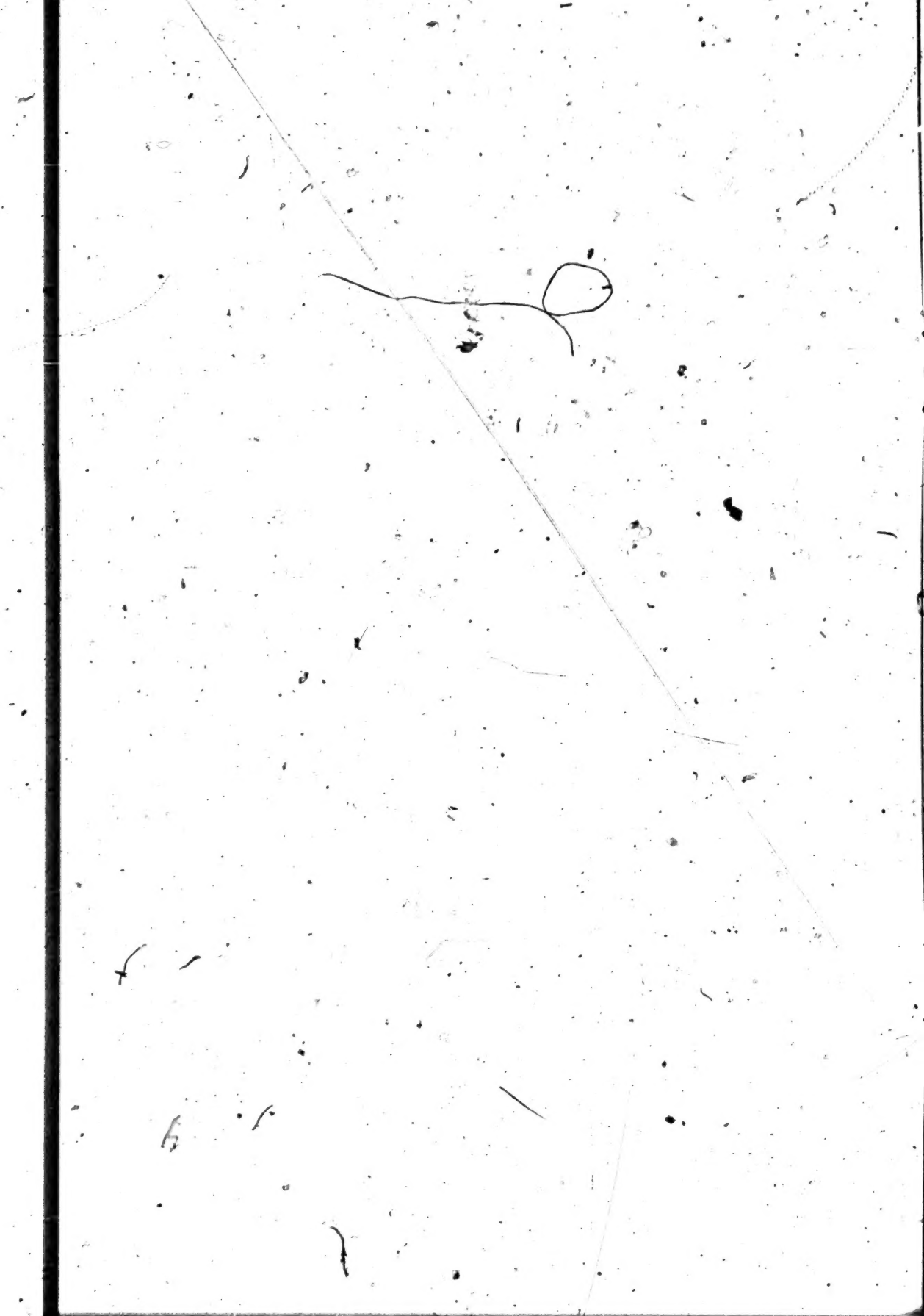

In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 1159

SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK, AS LIQUIDATOR OF MANHATTAN CASUALTY COMPANY, PETITIONER

v.

BANKERS LIFE AND CASUALTY COMPANY, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

The Solicitor General, on behalf of the Securities and Exchange Commission, is filing this brief *amicus curiae* because this case presents an important question in the administration of the Securities Exchange Act of 1934 which this Court should review. [1]

[1] While we recognize that this brief is not timely filed under this Court's Rules, it has not been possible to file it at an earlier date and we believe the importance of the question nonetheless warrants the expression of the Commission's views. We note that the parties will not be prejudiced by the resulting delay. Even allowing a reasonable time for response, it is evident that consideration of the petition will be had during the present term of